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Quarterly Market Environment & Considerations

Third Quarter 2022

Market review & outlook

Another Difficult Quarter for Stocks and Bonds

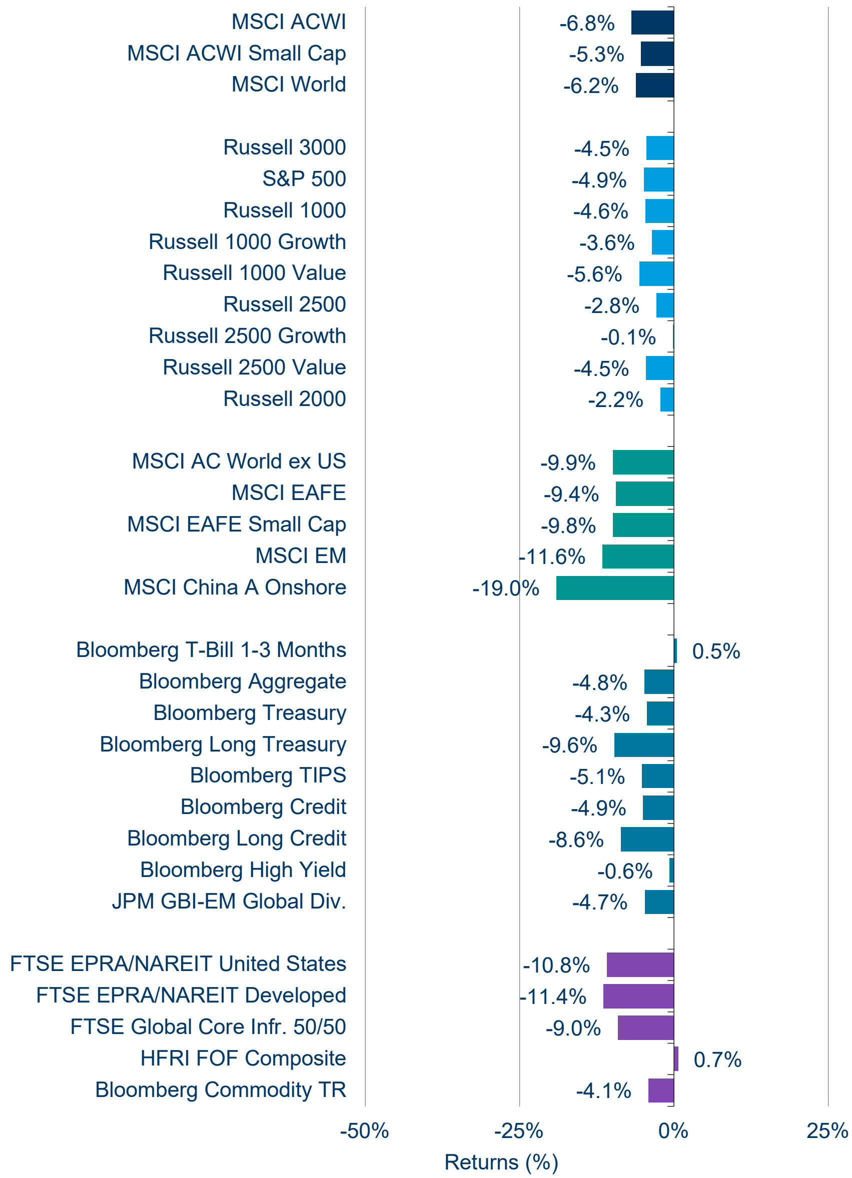
- Global markets continued their downtrend in the third quarter. Fed Chair Powell's speech at Jackson Hole in August dashed hopes that the Fed would consider pausing its tightening cycle. After recovering in July, both equity and bond markets broke through June lows.
- As a result of hawkish Fed guidance, bond markets ratcheted up expectations for this cycle's terminal interest rate from 3.25% at the end of July to 4.5%, which rippled through the yield curve. The 10-year Treasury yield briefly reached 4% in late-September, ending the month at 3.8%.
- The Bloomberg Aggregate Bond Index fell a further 5% in Q3, leaving it down 15% this year. The MSCI ACWI index fell 7% for the quarter and 25% this year. The simultaneous drawdown in both stocks and bonds has left a traditional 60/40 portfolio down 21% year-to-date.

Outlook Remains Uncertain

- The drawdown in stocks and bonds this year appears to be a reasonable response to the shift in Fed policy to combat inflation and the resulting uncertainty for economic growth. The decline in equities can be explained by the rise in interest rates putting downward pressure on valuations. The outlook for inflation and its impact on Fed policy likely will remain the key driver of the markets' direction.
- Encouragingly, inflationary pressures appear to be easing. The decline in energy prices in the US from their peaks should lead the headline inflation rate lower in the coming months. The gradual easing of supply side constraints and weaker demand could also slow core inflation. Easing inflation could mean that Fed hawkishness is near the peak.
- US economic activity has been nearly flat in 2022 and the tightening of financial conditions is only just beginning to be felt. The drag likely will intensify into 2023, increasing the risk of at least a mild recession. The good news is that household balance sheets remain strong, which should cushion household spending and prevent a deep downturn.
- A mild recession that reduces inflation could prove supportive of both stock and bond markets. The prospect of the Fed halting rate increases and a fall in longer-term interest rates could more than offset the negative impact of weak earnings for equities in a mild recession. The biggest downside risk we see for balanced portfolios is if inflation remains sticky even as the economy slows. This could require a more forceful Fed response and a deeper recession. This likely would result in continued weakness in stocks and bonds.

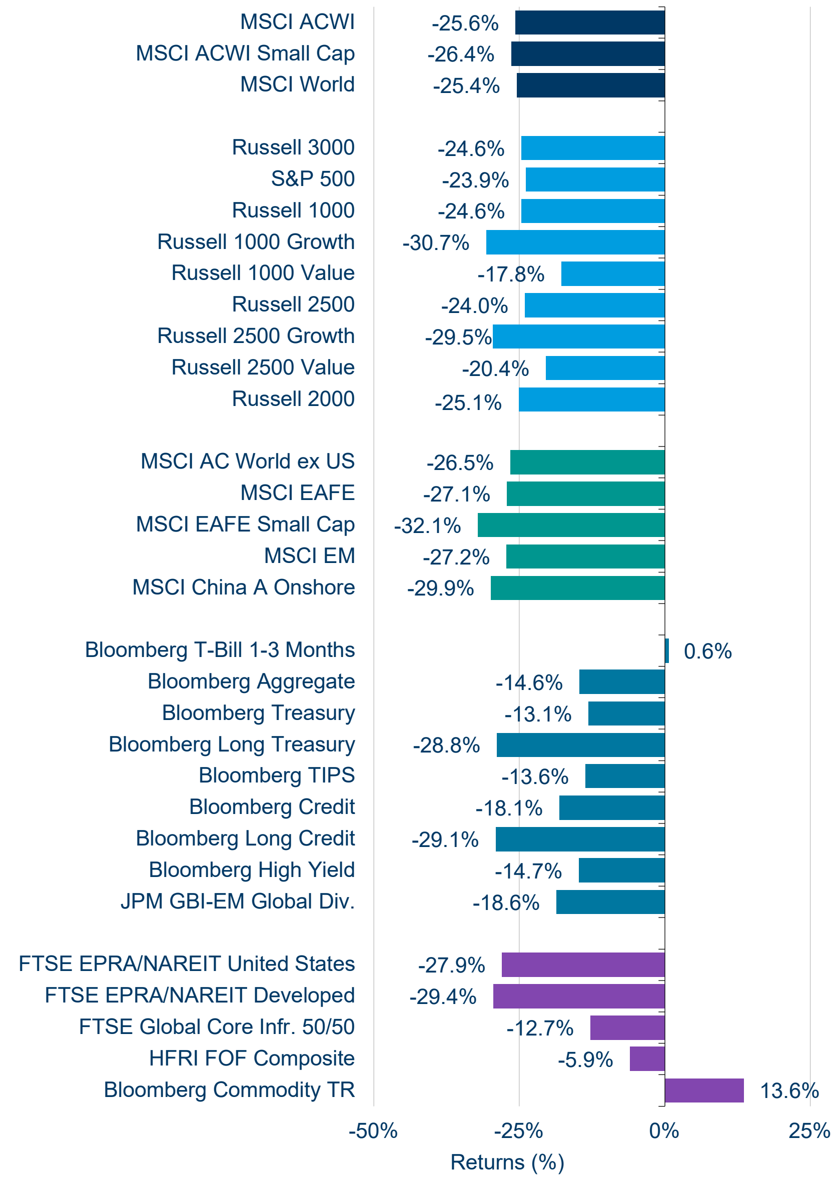
Performance summary

Market Performance
Third Quarter 2022



Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 9/30/22

Market Performance
Year-to-Date



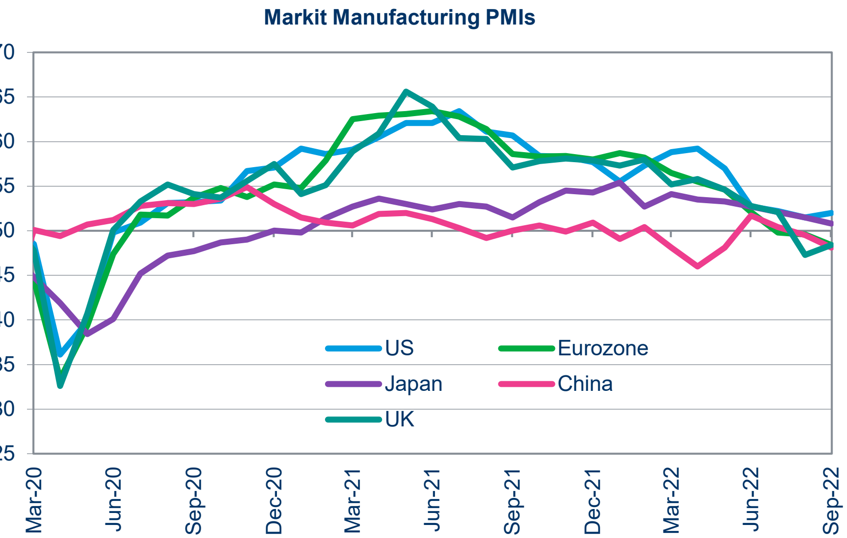
Source: Standard & Poor's, Russell, MSCI Barra, NAREIT, Bloomberg; as of 9/30/22

Past performance is no guarantee of future results

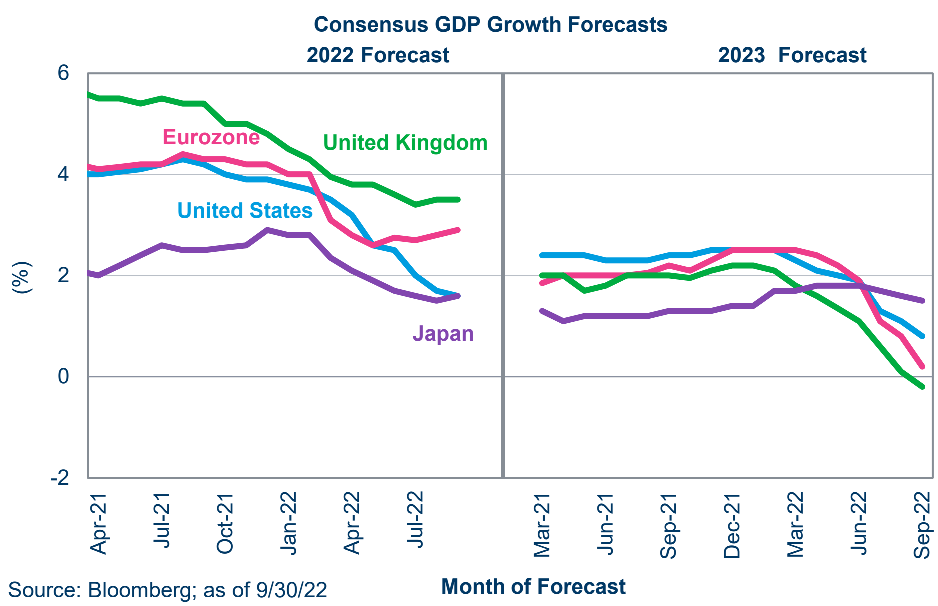
Economic fundamentals

Growth outlook deteriorating amid rising rates

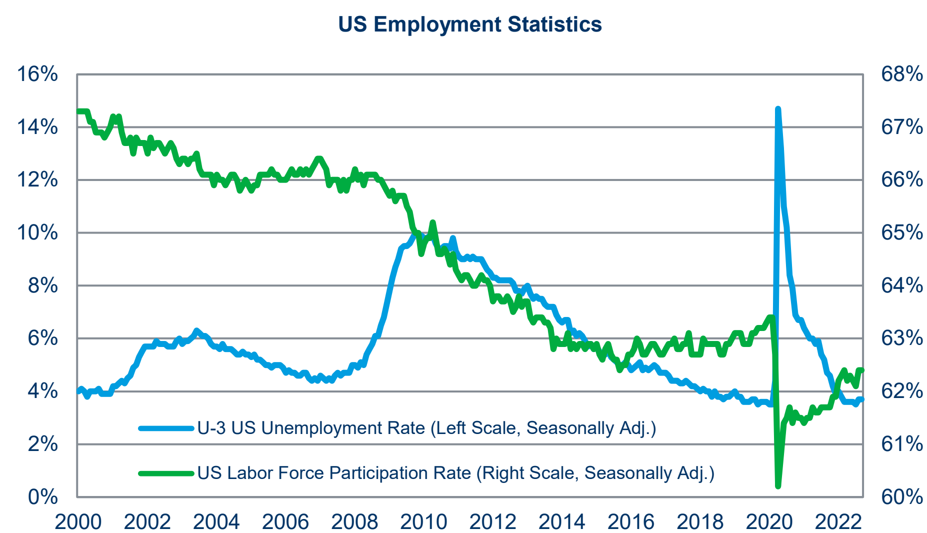
- The growth outlook continues to weaken as persistent inflation drives most central banks to maintain their hawkish stances. Consensus growth forecasts continue to move lower, particularly for 2023.
- Manufacturing PMIs barely remain in expansionary territory for the US and Japan, with most other regions having fallen to contractionary levels during Q3.
- The US labor market continues to show signs of resiliency. The US unemployment rate (U-3)[1] is currently 3.5%, matching its lowest level of the year. The labor force participation rate remains roughly one percentage point below its pre-COVID level.



Source: Bloomberg; as of 9/30/22



Source: Bloomberg; as of 9/30/22



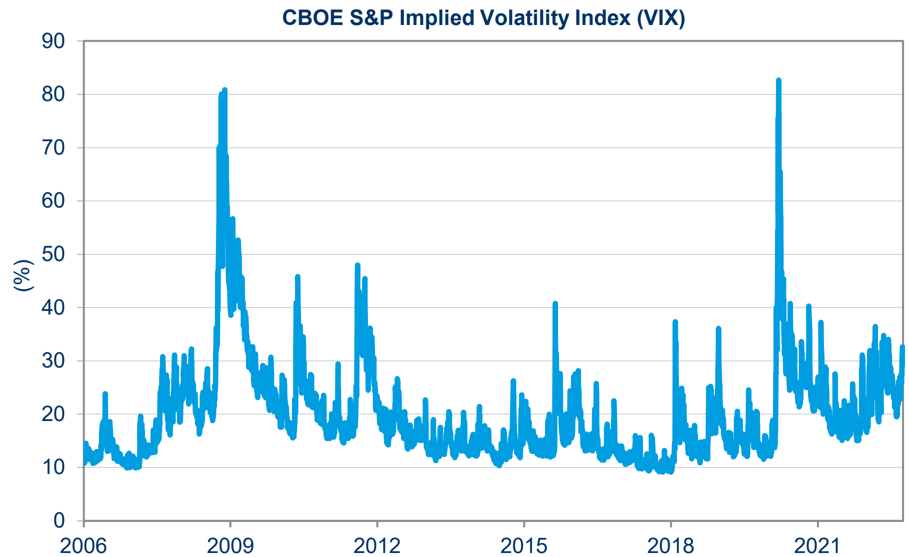
Source: Bureau of Labor Statistics; as of 9/30/22

[1] The U-3 unemployment rate represents the percentage of the civilian labor force that is jobless and actively seeking employment.

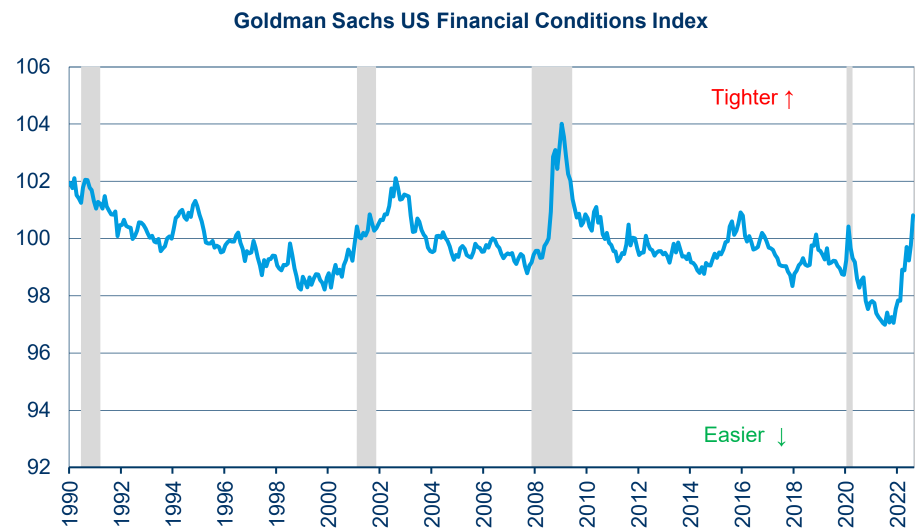
Risk factors

US inflation remains high

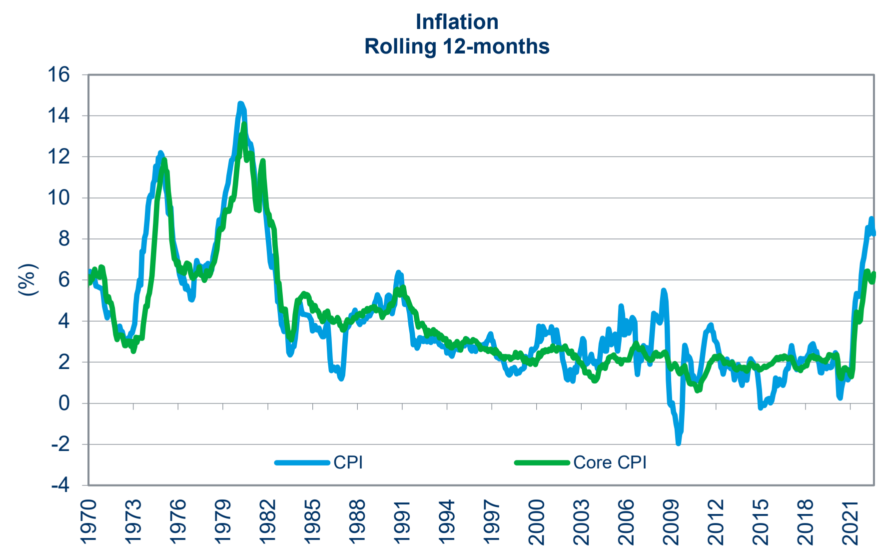
- US inflation remained elevated in Q3, and the Fed has maintained its aggressive pace of tightening. There are some signs that inflationary pressures may be weakening, but more sustained evidence is needed.
- The Russia - Ukraine conflict continues to cause geopolitical uncertainty and fears of potential escalation.
- The VIX volatility index rose from 29 to 31 during the quarter. The index had fallen to around 20 mid-quarter, before returning to elevated levels[1].
- Financial conditions continued to tighten during the quarter as rates rose. The Goldman Sachs US Financial Conditions Index is at the highest level in over six years.



Source: Bloomberg; as of 9/30/22



Source: Bloomberg; as of 9/30/22



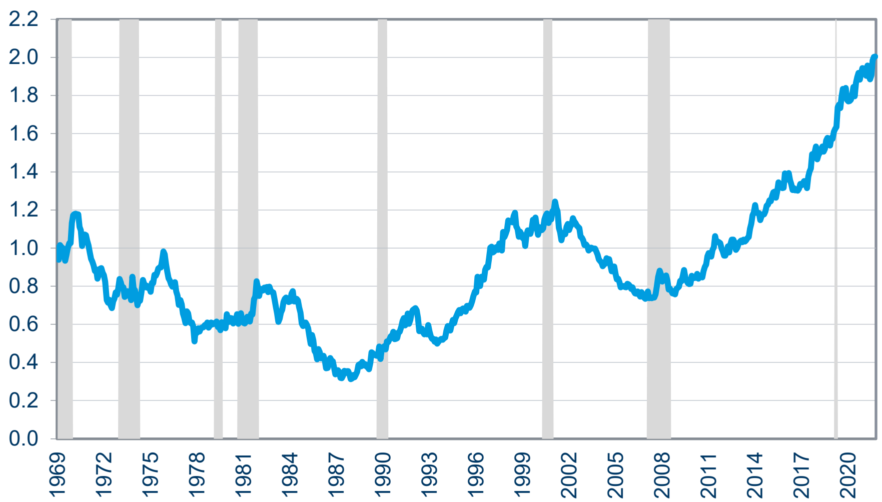
Source: Bloomberg; through 8/31/22

[1] Source: Bloomberg; as of 9/30/22

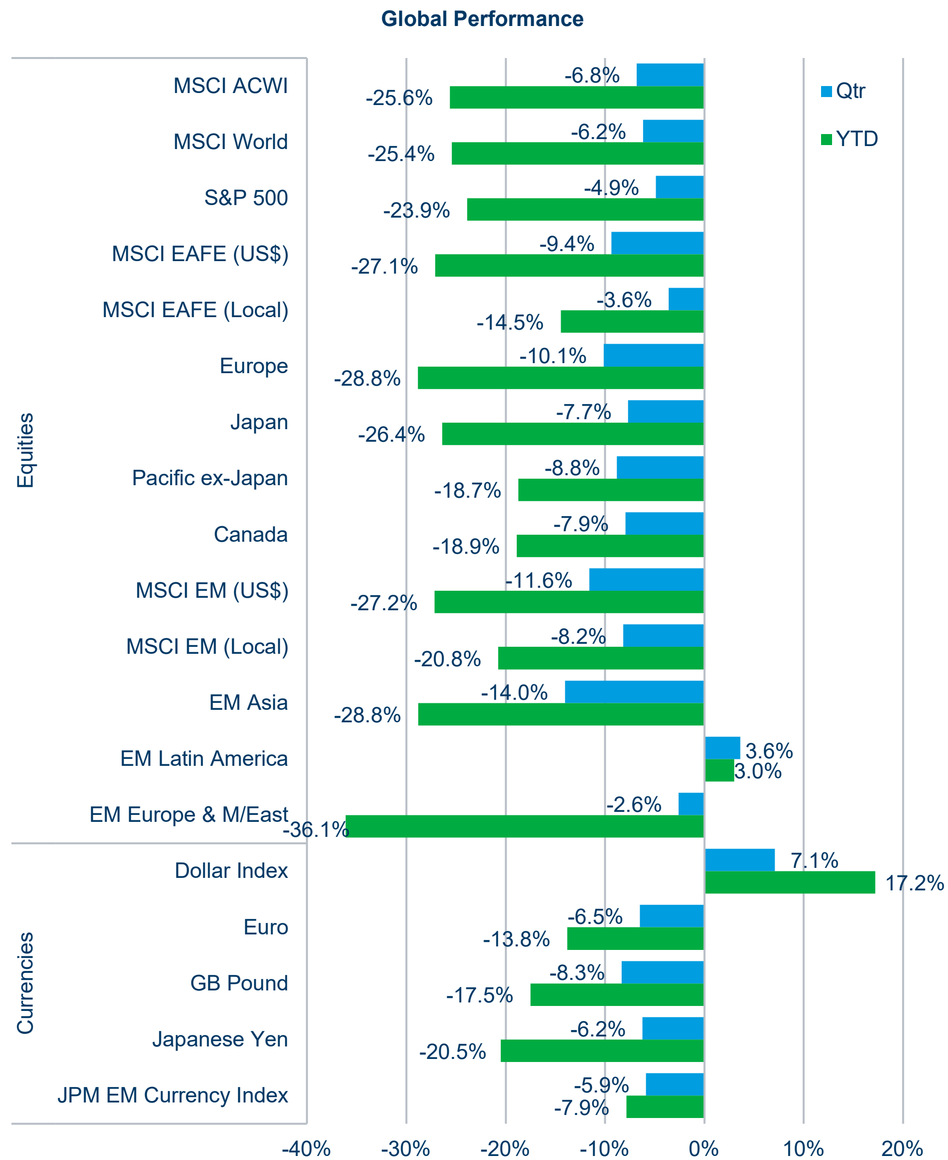
Regional equity returns

Global equities in a bear market year-to-date

- Global equities posted another quarter of declines in Q3, with the MSCI ACWI index falling 6.8% during the quarter. Year-to-date, the index has declined 25.6%.
- The S&P 500 fell 4.9% during the quarter, and is now down 23.9% year-to-date.
- International developed stocks declined 9.4% in Q3, leaving their year-to-date decline at 23.9%. A stronger dollar detracted 580 bps from US$ returns during the quarter.
- Emerging market equities fell 11.6% in Q3 and 27.2% year-to-date. Asian emerging markets were the worst performing region during the quarter, while Latin America posted modest gains.



Source: Datastream; as of 9/30/22

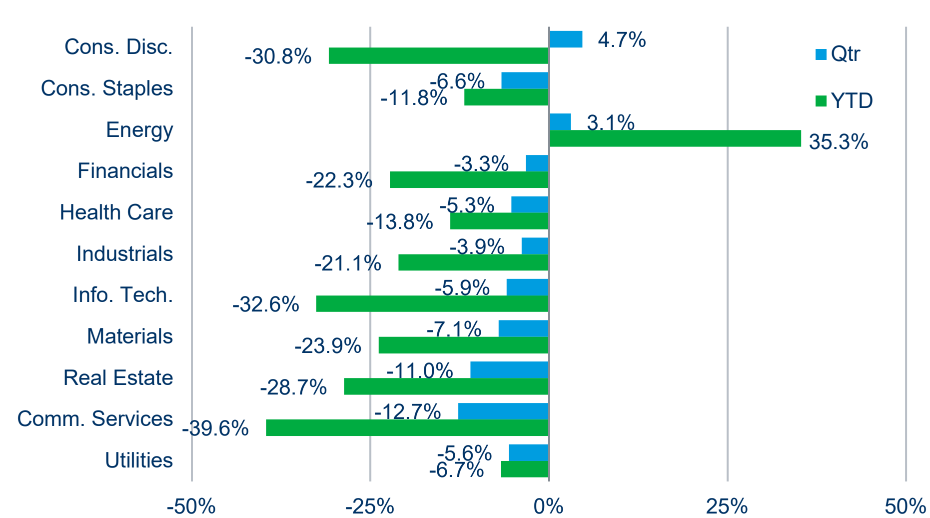


Source: Bloomberg, Datastream; as of 9/30/22

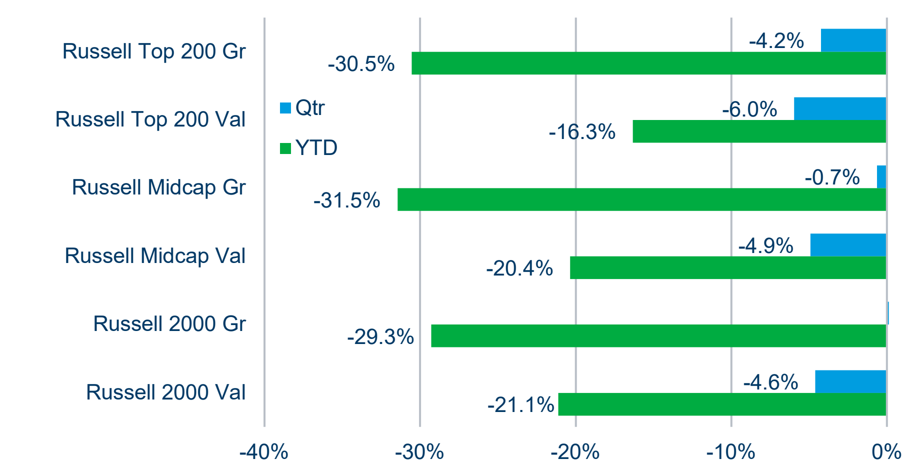
US equity factor and sector returns

Small-caps and growth stocks outperform despite rising rates

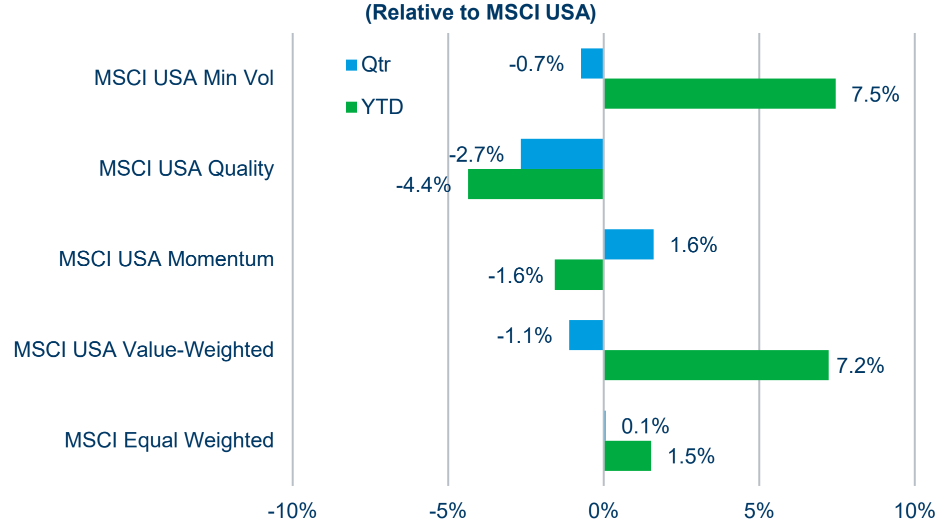
- Small-caps outperformed during Q3, although large-caps remain modestly ahead year-to-date. Value stocks have held up better than growth stocks in 2022, despite modest underperformance in Q3.
- The momentum factor outperformed during Q3, while the quality, minimum volatility and value factors generally lagged. The minimum volatility and value factors continue to show outperformance for the year-to-date period.
- The consumer discretionary and energy sectors were the only sectors with positive performance during Q3 and energy remains the only positive sector year-to-date. Communication services has been the worst performing sector during Q3 and year-to-date.



Source: Bloomberg; as of 9/30/22



Source: Datastream; as of 9/30/22



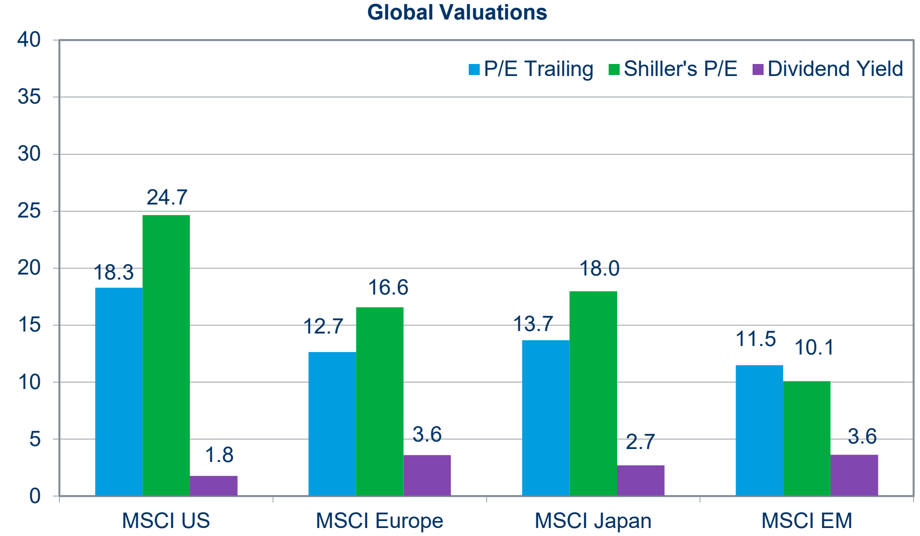
Source: MSCI; as of 9/30/22

Past performance is no guarantee of future results

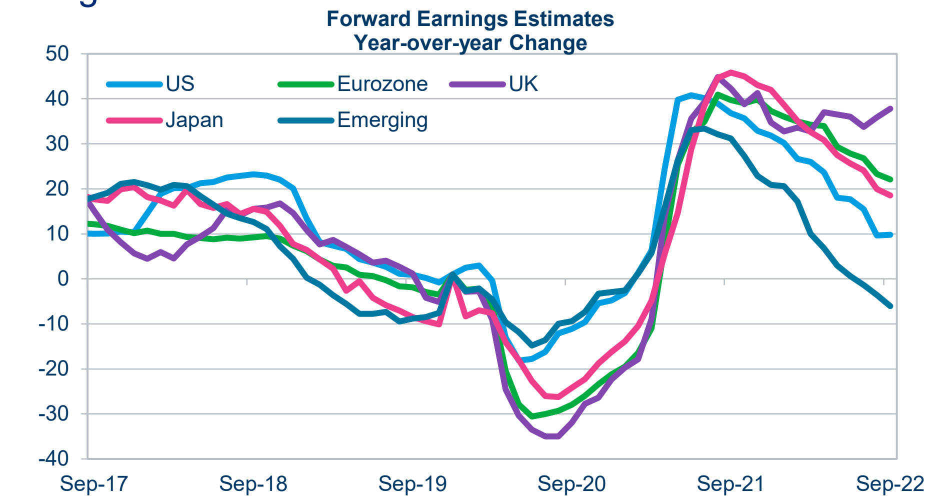
Equity fundamentals

Valuations improve amid weak performance

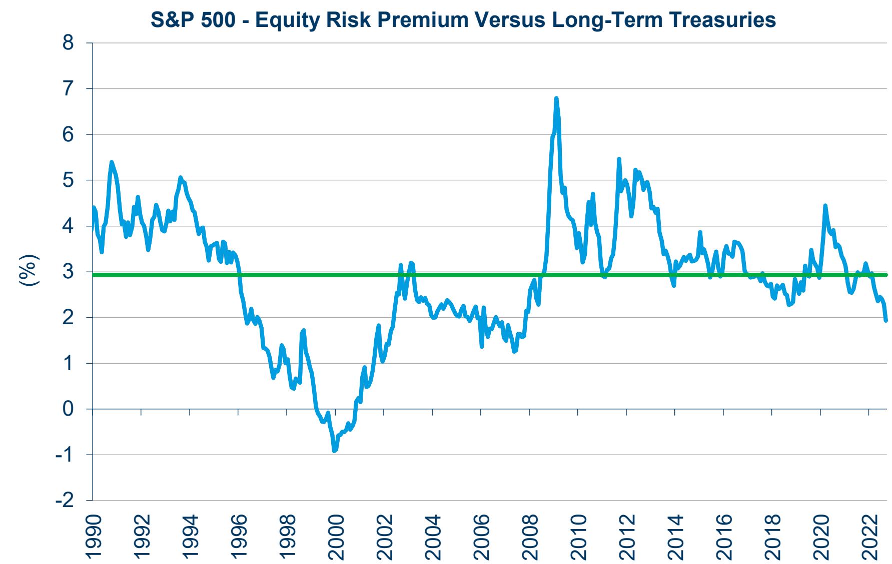
- Valuations modestly improved during the quarter as prices declined more than earnings. The trailing P/E ratio on the MSCI US Index fell from 18.9 to 18.3[1]. However, we estimate that the equity risk premium over long-term Treasuries fell from 2.4% to 1.9%[2] as the increase in yields outweighed improving valuations.
- International developed stocks remain more reasonably valued than US stocks, although Europe faces a challenging winter with elevated energy prices and potential supply shortages.
- Emerging market valuations remain more attractive than developed markets. Monetary policy remains accommodative in China, although challenges in the property sector and COVID restrictions continue to weigh on the outlook.



Source: Bloomberg, Datastream, Mercer; as of 9/30/22



Source: Datastream; as of 9/30/22



Source: Bloomberg, Datastream, Mercer; as of 9/30/22

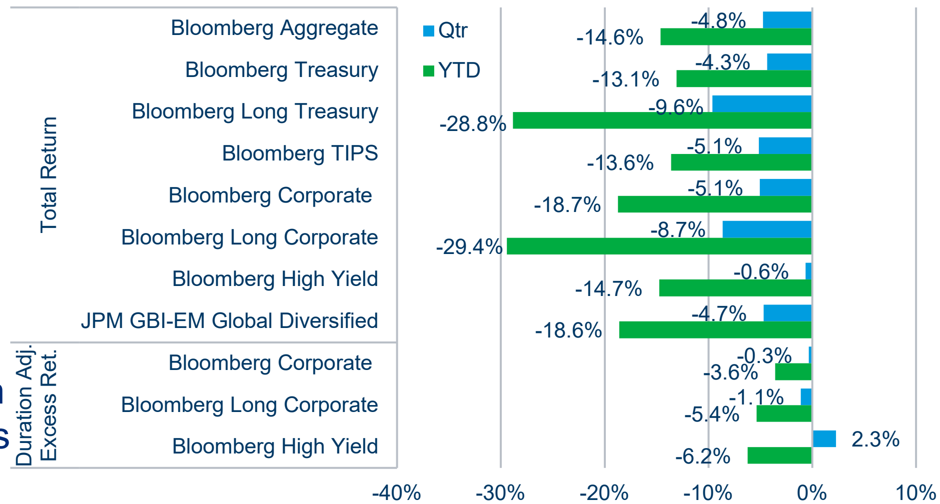
[1] Source: Refinitiv; as of 9/30/22
[2] Source: MSCI, Refinitiv, Mercer; as of 9/30/22

Interest rates and fixed income

Rising rates drive losses on bonds, as spreads see little change

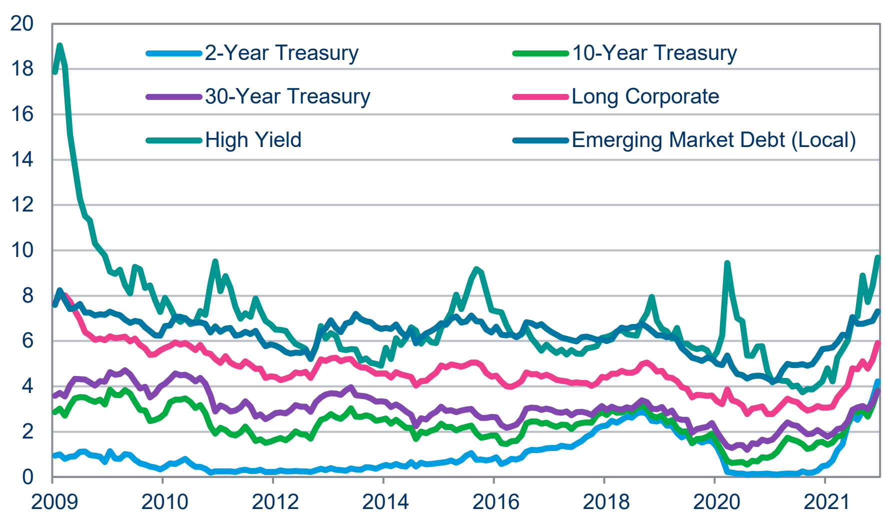
- The Bloomberg Aggregate declined 4.8% during the quarter. Treasuries declined 4.3%, but outperformed corporate bonds, which declined 5.1%. The yield curve shifted higher and flattened, with 3-month yields rising 161 bps, while 30-year yields rose by 65 bps[1].
- Credit spreads on investment-grade corporate bonds saw little change, rising 4 bps during the quarter to 1.6%, which is roughly 45 bps above the long-term median level[2].
- High yield bonds declined 0.6% during the quarter, even as credit spreads fell 16bps to 5.5%. High yield spreads are 90 bps above the long-term median level of 4.6%[2]. Local currency EMD declined 4.7% during Q3.

Fixed Income Performance



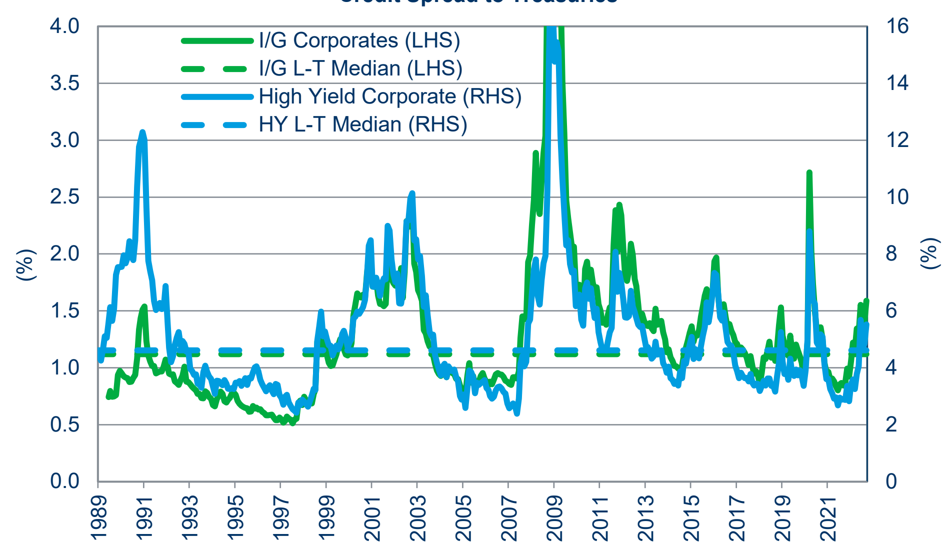
Source: Bloomberg, Datastream; as of 9/30/22

Yield History



Source: Bloomberg, Federal Reserve; as of 9/30/22

Credit Spread to Treasuries



Source: Bloomberg; as of 9/30/22

[1] Source: Federal Reserve; as of 9/30/22
[2] Source: Bloomberg, Mercer; as of 9/30/22

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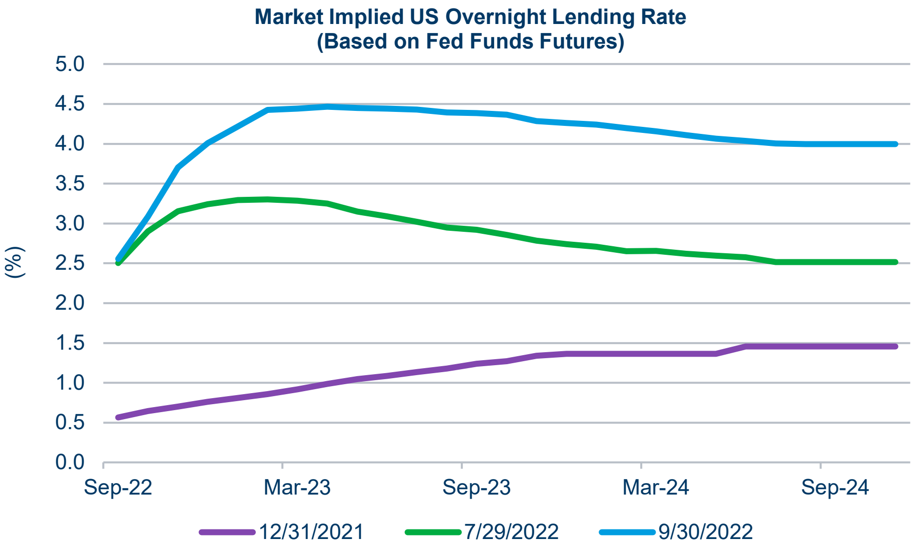
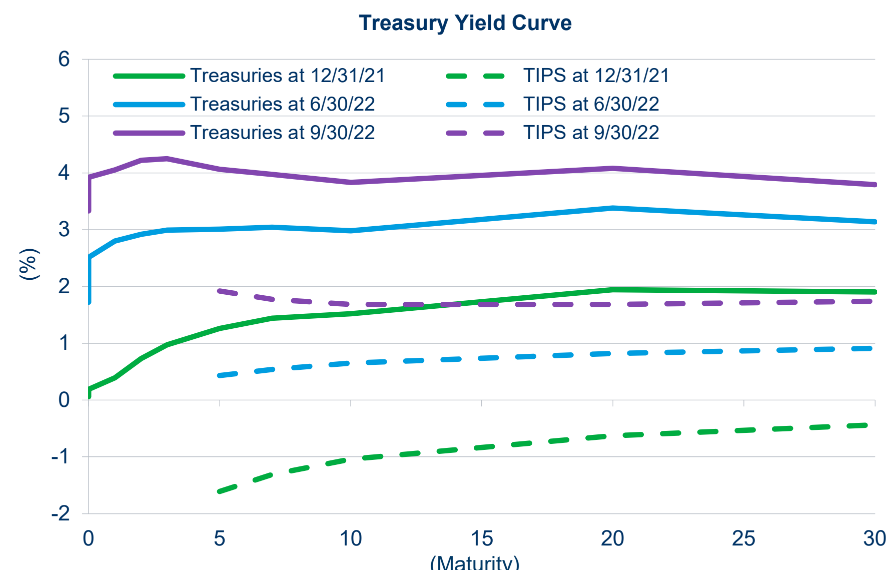
Monetary policy

Central banks maintain their hawkish stances

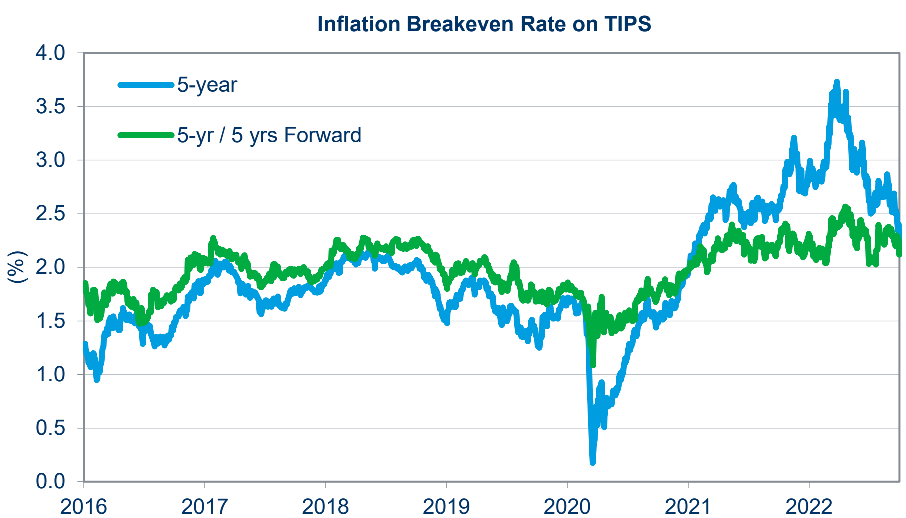
- In September, the Federal Reserve approved its third consecutive 75 basis point rate hike, bringing its policy rate to 3% - 3.25%. The Fed's dot plot and market pricing both suggest that the policy rate will be over 4% by the end of 2022.
- US inflation breakeven rates fell during the quarter, with 10-year inflation breakeven rates falling from 2.3% to 2.15%, slightly below the Fed's target of 2% PCE (roughly 2.5% CPI)[1].
- Overseas, most other central banks also raised rates, including the ECB and BOE. Japan and China were the only major regions without rate increases in Q3. In the UK, the BOE launched a temporary bond purchase program to ease conditions following the market's negative reaction to a new budget proposal.



Source: Bloomberg



Source: Federal Reserve; as of 9/30/22



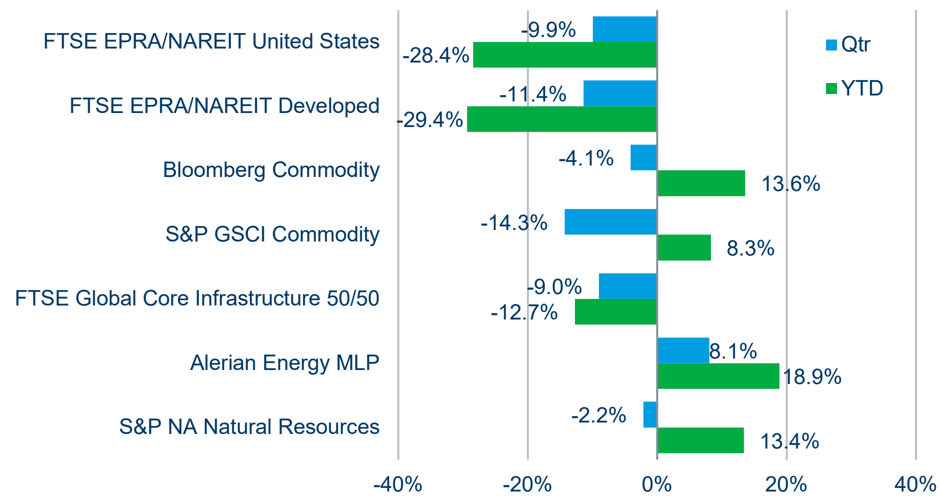
Source: Bloomberg, Mercer through 9/30/22

[1] Source: St. Louis Fed; as of 9/30/22

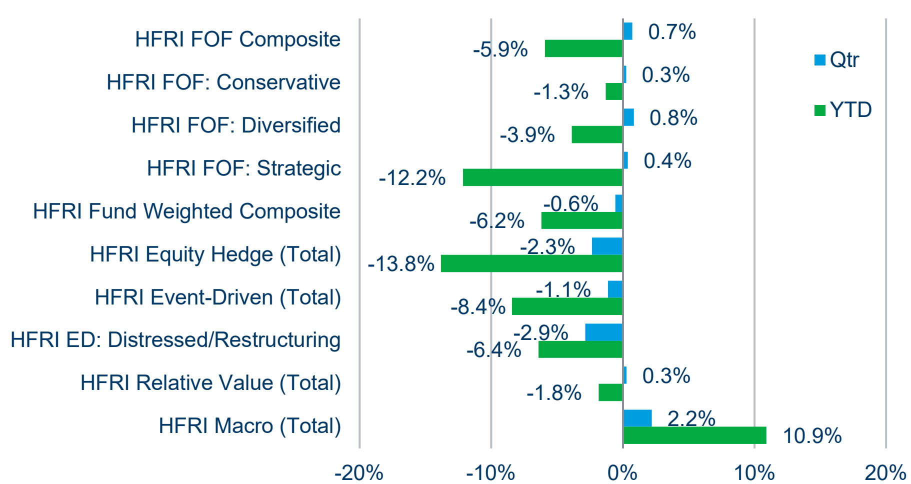
Alternative investment performance

REITs, infrastructure and commodities decline, hedge funds deliver gains

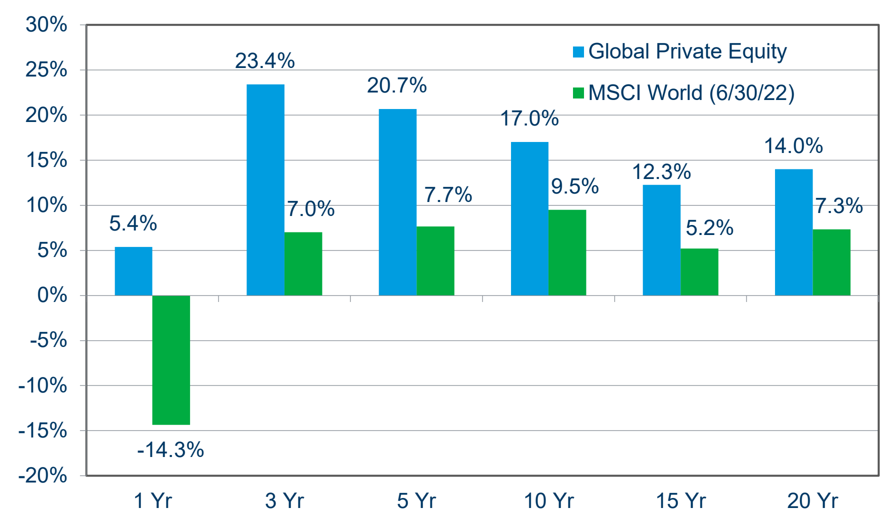
- REITs fell roughly 11% during Q3, faring worse than broader equity markets. Infrastructure stocks declined 9% during the quarter, but they have outperformed broader markets year-to-date.
- Commodities and natural resource stocks posted modest declines during the month on fears of a global slowdown, but returns remain positive year-to-date. MLPs returned over 8% during the quarter.
- The HFRI FOF Composite Index gained 0.7% in Q3, leaving it with a 5.9% decline, year-to-date[1]. Macro strategies have outperformed in 2022, while equity hedge and event-driven strategies have lagged.
- Global private equity outperformed global developed stocks over the most recent trailing periods[2].



Source: Bloomberg, Datastream; as of 9/30/22



Source: Hedge Fund Research; as of 9/30/22



Source: Burgiss, Bloomberg; as of 6/30/22

[1] Source: Hedge Fund Research; as of 9/30/22
[2] Source: Burgiss, Bloomberg; as of 6/30/22

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Valuations and yields

Ending September 30, 2022

Valuations

MSCI USA	9/30/2022	6/30/2022	3/31/2022	12/31/2021
Index Level	15757.5	16534.2	19866.9	20958.0
P/E Ratio (Trailing)	18.3	18.9	23.1	32.2
CAPE Ratio	24.7	26.6	33.0	36.2
Dividend Yield	1.8	1.7	1.4	1.5
P/B	3.6	3.8	4.7	4.4
P/CF	12.6	14.1	18.5	20.3
MSCI EAFE	**9/30/2022**	**6/30/2022**	**3/31/2022**	**12/31/2021**
Index Level	5610.4	6189.6	7240.4	7695.5
P/E Ratio (Trailing)	13.0	13.9	15.5	23.1
CAPE Ratio	14.0	15.6	17.0	17.9
Dividend Yield	3.6	3.4	2.9	2.4
P/B	1.5	1.6	1.8	1.8
P/CF	5.5	6.4	7.9	7.7
MSCI EM	**9/30/2022**	**6/30/2022**	**3/31/2022**	**12/31/2021**
Index Level	443.1	501.1	565.8	608.3
P/E Ratio (Trailing)	11.5	12.5	14.0	21.7
CAPE Ratio	10.1	11.6	13.7	14.5
Dividend Yield	3.6	3.1	2.5	2.0
P/B	1.5	1.7	1.8	2.0
P/CF	6.7	7.6	8.5	8.3

Source: Bloomberg, Thomson Reuters Datastream

Yields

Global Bonds	9/30/2022	6/30/2022	3/31/2022	12/31/2021
Germany – 10Y	2.11	1.34	0.55	-0.18
France – 10Y	2.72	1.92	0.98	0.20
UK – 10Y	4.09	2.23	1.61	0.97
Switzerland – 10Y	1.23	1.07	0.60	-0.14
Italy – 10Y	4.52	3.26	2.04	1.17
Spain – 10Y	3.29	2.42	1.44	0.57
Japan – 10Y	0.24	0.23	0.22	0.07
Euro Corporate	4.24	3.24	1.55	0.52
Euro High Yield	9.01	8.08	5.18	3.55
EMD ($)	9.57	8.56	6.42	5.27
EMD (LCL)	7.31	7.06	6.23	5.72
US Bonds	**9/30/2022**	**6/30/2022**	**3/31/2022**	**12/31/2021**
3-Month T-Bill	3.33	1.72	0.52	0.06
10Y Treasury	3.83	2.98	2.32	1.52
30Y Treasury	3.79	3.14	2.44	1.90
10Y TIPS	1.68	0.65	-0.52	-1.04
30Y TIPS	1.74	0.91	-0.03	-0.44
US Aggregate	4.75	3.72	2.92	1.75
US Treasury	4.13	3.09	2.42	1.23
US Corporate	5.69	4.70	3.60	2.33
US Corporate High Yield	9.68	8.89	6.01	4.21

Source: Bloomberg, Thomson Reuters Datastream

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Important Notices